

# THE IMPORTANCE OF PROPER VALUATION IN TRANSACTIONS BETWEEN AN ESOP AND THE SELLING OWNER

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## I. INTRODUCTION

Many entrepreneurs who own their own business may not be familiar with Employee Stock Ownership Plans (“ESOPs”). However, the National Center for Employee Ownership estimates that as of early 2010, there are over 10,000 such plans in existence, while the most recent available data suggests that ESOP assets are near \$900 billion.<sup>1</sup> ESOPs are created for various reasons, but they are most commonly used by closely-held business owners to either sell the business or to get liquidity out of the business.<sup>2</sup> While ESOPs can be a powerful tool for entrepreneurs, the creation of an ESOP must be undertaken with caution, especially as it relates to transactions between the selling owner and the ESOP. Flawed valuations of the portion of the business the ESOP is buying can lead to significant tax and legal issues that can quickly turn an otherwise beneficial transaction between a selling owner and the ESOP into a financial nightmare. Thus, while ESOPs certainly provide undeniable benefits to entrepreneurs and employees who participate in the plan, valuation of the business being sold to the ESOP must be carefully examined.

## II. WHAT IS AN ESOP?

The Internal Revenue Code defines an ESOP as a defined contribution plan designed to invest primarily in qualifying employer securities.<sup>3</sup> Qualifying employer securities are further defined as “common stock issued

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<sup>1</sup> *A Statistical Profile of Employee Ownership*, NAT’L CENTER FOR EMP. OWNERSHIP, <http://www.nceo.org/main/article.php/id/2> (last visited Mar. 24, 2011).

<sup>2</sup> *See How an Employee Stock Ownership Plan (ESOP) Works*, NAT’L CENTER FOR EMP. OWNERSHIP, <http://www.nceo.org/main/article.php/id/8> (last visited Mar. 24, 2011).

<sup>3</sup> I.R.C. § 4975(e)(7) (2006). An employee stock ownership plan is also defined in substantially the same manner in the Employee Retirement Income Security Act (ERISA). 29 U.S.C. § 1107(D)(6) (2006).

by the employer . . . which is readily tradable on an established securities market.”<sup>4</sup> However, when there is no readily tradable common stock, employer securities are defined as common stock issued by the employer which has a combination of dividend rights and voting power at least as great as the class of common stock having the greatest dividend rights and voting power.<sup>5</sup> Besides the requirement that the plan must be designed to invest primarily in employer securities, the plan must also meet various requirements listed in I.R.C. § 401(a) and I.R.C. § 409 in order to qualify as an ESOP.<sup>6</sup>

An ESOP is operated for the benefit of the employees of the employer and the employees are entitled to receive their respective allocation of securities when they leave the company.<sup>7</sup> When a company establishes an ESOP, the company sets up a trust and contributes shares of employer stock or cash which is used by the trust to purchase employer stock.<sup>8</sup> The securities are allocated to the employee participants based on the salary of each employee.<sup>9</sup> Company contributions to the ESOP in the form of stock or cash are tax-deductible by the company, which certainly provides a good incentive to contribute to an ESOP.<sup>10</sup>

ESOPs can be used for many purposes by entrepreneurs who own their own companies. ESOPs can be used as a business succession tool for closely held companies in order to ensure that management or family members take control of the company after the current leader exits the business.<sup>11</sup> This strategy allows an entrepreneur who is departing the company to give his interest in the company to his employees without requiring the employees to make an up-front contribution.

Another important reason for an entrepreneur to create an ESOP is to get liquidity out of the business.<sup>12</sup> A market may not exist for a closely held company, thus preventing the shares of the company from being publicly traded by the owner of the company. By selling his shares to an ESOP, the selling owner is able to create a market for his shares of the company, assuming that the shares are properly valued (to be discussed in detail below). In this manner, an entrepreneur who has a great deal of capital tied up in his or her company with no ready market for its shares can

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<sup>4</sup> I.R.C. § 409(l)(1) (2006).

<sup>5</sup> I.R.C. § 409(l)(2).

<sup>6</sup> I.R.C. § 409(a).

<sup>7</sup> *How an Employee Stock Ownership Plan (ESOP) Works*, *supra* note 2.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

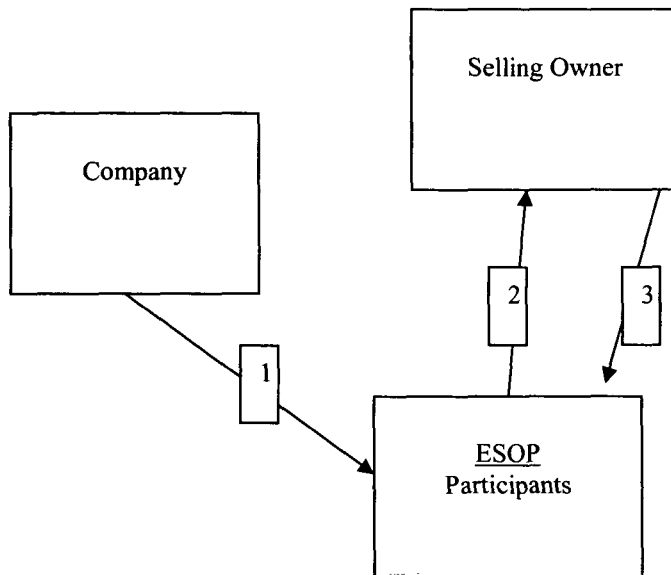
<sup>11</sup> Tim Jochim, Chair, Business Succession & ESOPs Group at Kegler, Brown, Hill, & Ritter Co., LPA, Presentation on the ESOP Business Model at The Ohio State University Office of Planned Giving (Apr. 2010).

<sup>12</sup> *Id.*

get some cash out of the business without giving up control of the entire company.

To illustrate the basic makeup of how a transaction would be structured with regard to the company, the selling owner, the ESOP, and the ESOP participants, see Figure 1 below<sup>13</sup>:

Figure 1:



In (1), the company makes a tax-deductible contribution of cash to the ESOP. Next, in (2) the trustee of the ESOP buys shares of company stock from the selling owner with the cash that has already been contributed by the company. Finally, in (3) the owner transfers the employer stock to the ESOP, which then allocates the stock to each participant's account based on compensation.

<sup>13</sup> *Id.* This illustration is adapted from a similar diagram produced during Tim Jochim's presentation.

## III. ESOP REQUIREMENTS

Section 409(a) of the Internal Revenue Code identifies three requirements which must be met before a proposed ESOP can qualify as a "tax credit employee stock ownership plan."<sup>14</sup> In order to satisfy these requirements, the proposed ESOP must be a defined contribution plan that: (1) meets the requirements of I.R.C. § 401(a); (2) is designed to invest primarily in employer securities; and (3) meets the requirements of various subsections of I.R.C. § 409.<sup>15</sup> The general conditions imposed by each of the three prerequisites will be discussed below.

*A. Requirements of I.R.C. § 401(a)*

While it is not possible to discuss all of the requirements of I.R.C. § 401(a) in detail in this paper, it will be useful to reference some of the more relevant provisions that are dealt with in that section. A trust organized for the exclusive benefit of an organization's employees or their beneficiaries can be recognized as a "qualified trust" if certain conditions are met.<sup>16</sup> The first condition deals with contributions to the trust—such contributions must be made by the employer, the employees or both.<sup>17</sup> Also, the purpose of the trust must be to eventually distribute the principal and income of the trust to the employees or their beneficiaries.<sup>18</sup>

One important requirement of § 401(a) establishes that a trust organized for the benefit of an employer's employees must not discriminate in favor of highly compensated employees in terms of benefits or contributions made by the employer.<sup>19</sup> The Internal Revenue Code § 401(a) provides some clarification on what is and is not discrimination. For instance, a classification made by the employer will not be considered discriminatory solely because contributions are made or benefits are distributed only for the benefit of salaried or clerical employees.<sup>20</sup> Furthermore, a plan will not be deemed discriminatory under § 401(a)(4) if the benefits or contributions made on behalf of employees under the plan bear a "uniform relationship to compensation."<sup>21</sup> Another provision to consider is § 401(a)(7), which demands that a trust purporting to be a qualified trust must meet the

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<sup>14</sup> I.R.C. § 409(a) (2006).

<sup>15</sup> *Id.*

<sup>16</sup> I.R.C. § 401(a) (2006).

<sup>17</sup> I.R.C. § 401(a)(1). Contributions may also be made by another employer who is entitled to deduct the contributions under another provision of the Internal Revenue Code or by a charitable remainder trust in accordance with a "qualified gratuitous transfer." *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> I.R.C. § 401(a)(4).

<sup>20</sup> I.R.C. § 401(a)(5)(A).

<sup>21</sup> I.R.C. § 401(a)(5)(B).

requirements of § 411, which deals with the minimum vesting standards that must be satisfied.<sup>22</sup>

One final requirement of § 401(a) is applicable only to employers who establish a defined contribution plan and whose stock is not readily tradable on an established market.<sup>23</sup> Furthermore, the provision comes into play only if more than ten percent of the trust's total assets, after acquiring securities of the employer, consist of securities of the employer.<sup>24</sup> If these two elements are met, the trust can only be deemed a qualified trust if the requirements of § 409(e) (discussed below, but essentially dealing with voting rights) are also met.<sup>25</sup>

### *B. ESOP Must be Designed to Invest Primarily in Employer Securities*

A plan will qualify as an ESOP only if the plan specifically states that it is designed to invest primarily in employer securities.<sup>26</sup> An ESOP does not have to invest entirely in qualifying employer securities, as it may invest part of its assets in non-employer securities, but the primary investment asset of the ESOP should be employer securities.<sup>27</sup>

### *C. Requirements of I.R.C. § 409*

In order to meet the requirements of I.R.C. § 409, a proposed ESOP must satisfy the conditions of subsections (b), (c), (d), (e), (f), (g), (h) and (o) of I.R.C. § 409.<sup>28</sup> Many of these requirements deal with the rights of a participant in the ESOP. Although some subsections are more relevant than others, each applicable subsection of I.R.C. § 409 is discussed below.

Section 409(b) contemplates the method by which employer securities are allocated in the ESOP.<sup>29</sup> Employer securities may not be allocated to participants in the plan based on a formula created by the employer or the ESOP trustee—the allocation formula must conform to the method imposed by § 409(b).<sup>30</sup> The plan must provide for the allocation of all of the employer securities purchased by the ESOP to the accounts of participants in the plan who are entitled to receive allocations of employer securities.<sup>31</sup> Furthermore, the amount of employer securities allocated to each eligible

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<sup>22</sup> I.R.C. § 401(a)(7).

<sup>23</sup> I.R.C. § 401(a)(22)(A).

<sup>24</sup> I.R.C. § 401(a)(22)(B).

<sup>25</sup> I.R.C. § 401(a)(22).

<sup>26</sup> 29 C.F.R. § 2550.407d-6(b) (2010).

<sup>27</sup> *Id.*

<sup>28</sup> I.R.C. § 409(a)(3) (2006).

<sup>29</sup> I.R.C. § 409(b).

<sup>30</sup> *Id.*

<sup>31</sup> I.R.C. § 409(b)(1)(A).

participant must represent substantially the same proportion to the total amount of securities allocated in that plan year as the amount of compensation paid to the participant out of the total compensation paid to all of the plan's participants that year.<sup>32</sup> However, there is one important limitation on this calculation. Compensation in excess of \$100,000 per year for a plan participant is disregarded for the purposes of figuring the allocation ratio.<sup>33</sup> Thus, highly paid employees who are plan participants will only receive allocations of employer securities based on the first \$100,000 of their yearly compensation.

Section 409(c) states that all participants in the ESOP must have non-forfeitable rights to any employer securities that are allocated to their individual accounts.<sup>34</sup> This requirement protects a plan participant's investment from the whims of the plan administrator, which could be especially relevant when the participant is contemplating leaving the company or is facing disciplinary action. By requiring that all participants have non-forfeitable rights to their respective allocation of employer securities, § 409(c) denies plan administrators the power to threaten a plan participant with the seizure of allocated employer securities.

Section 409(d) imposes an important limitation on distributions of employer securities from the plan. Employer securities that are allocated to a plan participant's account may not be distributed out of that account until seven years after the month in which the securities were allocated.<sup>35</sup> This rather severe restriction is tempered, however, by the exceptions provided in § 409(d). The seven-year waiting period on distributions does not apply when the plan participant dies, becomes disabled, is separated from service, or the plan itself is terminated.<sup>36</sup> These exceptions allow for the participant

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<sup>32</sup> I.R.C. § 409(b)(1)(B). This requirement is easier to understand when expressed as a formula. Assume the variable IA (individual allocation) equals the amount of employer securities allocated to a particular plan participant. Variable TS (total securities) equals the total amount of employer securities purchased or transferred to the ESOP that year. Variable IC (individual compensation) represents the amount of compensation paid to our same plan participant. Variable TC (total compensation) is the total amount of compensation paid to plan participants that year. In order to satisfy § 409(b)(1)(B), IA divided by TS must be substantially equal to IC divided by TC. Essentially,  $IA / TS = IC / TC$ . Therefore, the total amount of securities allocated to our plan participant will be the ratio of  $IC / TC$ , multiplied by the total amount of employer securities purchased or transferred to the ESOP that year.

<sup>33</sup> I.R.C. § 409(b)(2).

<sup>34</sup> I.R.C. § 409(c).

<sup>35</sup> I.R.C. § 409(d).

<sup>36</sup> I.R.C. § 409(d)(1). There are two other exceptions to the typical seven year restriction. The restriction does not apply when a plan participant transfers employment from a selling corporation to an acquiring corporation and the acquiring corporation is acquiring substantially all of the selling corporation's

to collect on his or her assets in the plan in situations where it would be impracticable or unnecessary for the plan to continue to hold the employer securities allocated to the participant.

Section 409(e) deals with voting rights that must be granted to participants in the ESOP.<sup>37</sup> This section creates different requirements for employers who have a registration-type class of securities and those who do not.<sup>38</sup> For employers who do have a registration-type class of securities, the ESOP will satisfy the requirements of § 409(e) if each participant in the plan has the right to direct how his or her allocated employer securities will be voted when the class of securities held has a right to vote.<sup>39</sup> For employers who do not have a registration-type class of securities (such as closely held companies or many businesses run by entrepreneurs), the ESOP will meet the standards of § 409(e) if each participant in the plan is entitled to direct how his or her allocated employer securities will be voted whenever there is a corporate matter that requires a shareholder vote, such as a recapitalization or liquidation of the business.<sup>40</sup> Furthermore, for employers without a registration-type class of securities, each plan participant is entitled to one vote for each issue, and the trustee of the ESOP must vote any shares held by the plan in the same proportion as the participants in the plan voted.<sup>41</sup>

Subsections (f) and (g) of § 409 are of less importance, but still bear mentioning. Section 409(f) mandates that any ESOP must be established before the employer's due date for its corporate tax return in the first year in which the employer claims a tax credit for the plan.<sup>42</sup> Section 409(g) states that securities transferred to the plan must stay in the plan even if the employer's tax credit based on those transfers of securities has been recaptured or re-determined.<sup>43</sup>

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assets used in its trade or business. I.R.C. § 409(d)(2). The restriction also does not apply when a selling corporation disposes of its interest in a subsidiary and the plan participant continues employment with the subsidiary. I.R.C. § 409(d)(3).

<sup>37</sup> I.R.C. § 409(e).

<sup>38</sup> *Id.* A registration-type class of securities can be generally defined as a class of securities that must be registered under the Securities Exchange Act of 1934. I.R.C. § 409(e)(4).

<sup>39</sup> I.R.C. § 409(e)(2).

<sup>40</sup> I.R.C. § 409(e)(3). Other examples of corporate matters that would require a vote include the approval or disapproval of any corporate merger or consolidation, a reclassification, a dissolution, or the sale of substantially all the assets of the trade or business. *Id.*

<sup>41</sup> I.R.C. § 409(e)(5). Thus, for example, if sixty percent of the plan participants voted in favor of a merger, sixty percent of any employer securities held by the ESOP itself would have to be voted in favor of the merger.

<sup>42</sup> I.R.C. § 409(f).

<sup>43</sup> I.R.C. § 409(g).

One of the most important provisions of § 409 is contained in § 409(h). This section provides participants in the plan with a put option—essentially, employees have the right to demand employer securities or have one's securities in the plan purchased by the ESOP.<sup>44</sup> When the employer securities held by a plan participant are traded on an established market, an ESOP meets the requirements of § 409(h) if the participant's benefits are distributed in the form of employer securities.<sup>45</sup> However, when the employer securities held by the plan participant are not readily tradable on an established market, the participant has the right to require that the employer repurchase the employer securities under a fair valuation formula.<sup>46</sup> This put option provided to participants in plans that hold employer securities not readily tradable on an established market must last for sixty days after the distribution of employer securities to the participant.<sup>47</sup> If the ESOP participant does not exercise the option within sixty days, the employer must also offer the option for an additional period of at least sixty days in the following plan year.<sup>48</sup>

Finally, § 409(o) sets forth the distribution and payment requirements of the ESOP.<sup>49</sup> The plan must begin distribution of the participant's account balance in the plan within one year after the close of the plan year in which the participant "separates from service by reason of the attainment of normal retirement age under the plan, disability, or death."<sup>50</sup> If the participant separates from service in any other situation, the plan must begin distribution of the account balance within one year after the close of the plan year, which is the fifth plan year since the participant separated from service.<sup>51</sup>

Unless the participant in the ESOP elects otherwise, § 409(o) also mandates that the distributions must be made in a predetermined prescribed manner. The distribution of the account balance of the participant must be made in substantially equal periodic payments over a period not longer than five years.<sup>52</sup> However, if the account balance is larger than \$800,000, the

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<sup>44</sup> I.R.C. § 409(h).

<sup>45</sup> I.R.C. § 409(h)(1)(A).

<sup>46</sup> I.R.C. § 409(h)(1)(B).

<sup>47</sup> I.R.C. § 409(h)(4).

<sup>48</sup> *Id.*

<sup>49</sup> I.R.C. § 409(o).

<sup>50</sup> I.R.C. § 409(o)(1)(A)(i).

<sup>51</sup> I.R.C. § 409(o)(1)(A)(ii). However, this provision does not apply if the participant is re-employed by the employer before the distribution is required to be made to the participant. *Id.*

<sup>52</sup> I.R.C. § 409(o)(1)(C)(i).



distributions may be made over a period of five years, plus an additional year for each \$160,000 by which the balance exceeds \$800,000.<sup>53</sup>

#### IV. TRANSACTIONS BETWEEN AN ESOP AND THE SELLING OWNER

##### A. *Prohibition on ESOP Transactions with Disqualified Persons*

Transactions between an ESOP and the selling owner of a company are complicated by certain provisions in the Employee Retirement Income Security Act ("ERISA"). Specifically, § 1106 of ERISA prohibits certain transactions between a plan and parties in interest when there is a high risk of fiduciary self-dealing.<sup>54</sup> A party in interest for an employee benefit plan is defined in ERISA as well.<sup>55</sup> Although many examples are given for people who would be considered parties in interest, the most relevant individuals who qualify as parties in interest are: (1) an employer of employees covered by the ESOP; (2) employees, officers and directors of the employer; and (3) ten percent shareholders of the employer.<sup>56</sup> A fiduciary of a plan such as an ESOP may not allow the plan to engage in a transaction with a party in interest if he or she knows or should know that the transaction is a direct or indirect sale or exchange of any property between the plan and the party in interest.<sup>57</sup>

The Internal Revenue Code defines a disqualified person in much the same manner as a party in interest is defined in ERISA.<sup>58</sup> Similarly, the Internal Revenue Code lists several transactions that are prohibited between an ESOP and a disqualified person.<sup>59</sup> These transactions are substantially the same as the list of prohibited transactions in ERISA.

In general, a fiduciary of an ESOP must execute his duties with regard to the "prudent man" standard, which dictates that the fiduciary shall perform with "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of

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<sup>53</sup> I.R.C. § 409(o)(1)(C)(ii). These dollar amounts may be adjusted by the Secretary for changes in the cost-of-living. I.R.C. § 409(o)(2).

<sup>54</sup> 29 U.S.C. § 1106 (2006).

<sup>55</sup> *Id.*

<sup>56</sup> See 29 U.S.C. § 1002(14) (2006).

<sup>57</sup> 29 U.S.C. § 1106(a)(1)(A). Other examples given in the statute that constitute prohibited transactions include the lending of money between the plan and a party in interest, the furnishing of goods or services between the plan and a party in interest and the transfer of plan assets to a party in interest. See 29 U.S.C. § 1106(a)(1).

<sup>58</sup> I.R.C. § 4975(e)(2) (2006).

<sup>59</sup> I.R.C. § 4975(c).

a like character and with like aims.”<sup>60</sup> Furthermore, the ESOP fiduciary must perform his duties for the exclusive purpose of providing the participants in the ESOP with benefits and defraying any reasonable expenses of administering the ESOP.<sup>61</sup> The restrictions in ERISA and the Internal Revenue Code would seem to prevent any transactions between an ESOP and a selling owner, since a selling owner who owns more than ten percent of the company will be considered a disqualified person and a party in interest. Thus, an owner who owns more than ten percent of the company would not be permitted to sell any company securities to the ESOP. However, recognizing that this result would have serious negative consequences on beneficial employee benefit plans such as ESOPs, Congress provided selling owners with a loophole to escape the “prohibited transaction” moniker. This important exemption is discussed below.

#### *B. Exemption from Prohibition on Transactions with Disqualified Persons*

Without an exemption from the prohibition on transactions between an ESOP and a party in interest (or disqualified person, in terms of the Internal Revenue Code), any transaction between a selling owner and the ESOP itself would be prohibited.<sup>62</sup> To prevent this undesirable result, ERISA contains a provision that explicitly deals with transactions between parties in interest and ESOPs.<sup>63</sup> The prohibition on transactions between parties in interest and ESOPs does not apply to a plan’s acquisition or sale of qualifying employer securities<sup>64</sup> if the sale or acquisition is for adequate consideration.<sup>65</sup>

The definition of adequate consideration becomes important in transactions between a selling owner and an ESOP. Valuation of the securities being sold to the ESOP is a cardinal concern for all parties involved so that a great deal of hassle and possibly financial loss can be avoided. The adequate consideration test focuses on the conduct of the fiduciaries of the ESOP in determining the price that is to be paid to the selling owner, not the price itself.<sup>66</sup> The fiduciary for the ESOP has the burden of proving that the ESOP received adequate consideration for its purchase of the employer’s stock.<sup>67</sup>

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<sup>60</sup> 29 U.S.C. § 1104(a)(1)(B) (2006).

<sup>61</sup> 29 U.S.C. § 1104(a)(1)(A).

<sup>62</sup> See 29 U.S.C. § 1106(a)(1).

<sup>63</sup> See 29 U.S.C. § 1108(e) (2006).

<sup>64</sup> A qualifying employer security is stock, a marketable obligation or an interest in a publicly traded partnership. 29 U.S.C. § 1107(d)(5) (2006).

<sup>65</sup> 29 U.S.C. § 1108(e)(1).

<sup>66</sup> *Henry v. Champlain Enters.*, 445 F.3d 610, 620 (2d Cir. 2006).

<sup>67</sup> *Id.* at 619.

Adequate consideration is defined in ERISA based on whether or not the plan is purchasing a security for which there is a generally recognized market.<sup>68</sup> If the ESOP is purchasing a security for which there is a generally recognized market, adequate consideration is equal to the current price of the security on a national exchange.<sup>69</sup> However, if the ESOP is purchasing a security that does not trade on a generally recognized market (as in most closely held businesses), adequate consideration is defined as the fair market value of the asset being purchased, as determined in good faith by the trustee or fiduciary of the ESOP.<sup>70</sup>

The U.S. Department of Labor has provided further elaboration on what constitutes adequate consideration when there is no generally recognized market for an employer security being purchased by the ESOP. One proposed regulation states that adequate consideration must reflect the asset's fair market value and the valuation process must be conducted in good faith.<sup>71</sup> Fair market value is in turn defined as "the price at which an asset would change hands between a willing buyer and a willing seller" when neither party is under any compulsion to buy or sell, "and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset."<sup>72</sup> Additionally, the valuation process must be conducted by the ESOP's fiduciary in good faith, which is an objective standard and therefore focuses on the fiduciary's conduct rather than any subjective measure of good faith.<sup>73</sup>

Courts will examine whether a fiduciary has met his obligations to the ESOP by asking whether, at the time of the transaction between the selling owner and the ESOP, the fiduciary employed the appropriate methods to determine the value of the securities being purchased from the owner of the business.<sup>74</sup> Furthermore, a proper determination of fair market value by the ESOP fiduciary depends on whether the parties involved in the transaction are well informed about the asset and the market for the asset, as described in the proposed regulation by the Department of Labor.<sup>75</sup> As long as a fiduciary employs appropriate methods to value the securities being purchased from the selling owner and conducts the valuation in good faith, a transaction between a selling owner and an ESOP will usually be deemed to be made for adequate consideration and avoid being labeled as a prohibited transaction.

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<sup>68</sup> 29 U.S.C. § 1002(18) (2006).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (proposed May 17, 1988) (to be codified at 29 C.F.R. pt. 2510).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Henry v. Champlain Enters.*, 445 F.3d 610, 618 (2d Cir. 2006).

<sup>75</sup> *Id.* at 619.

*C. Consequences of Engaging in a Prohibited Transaction*

One of the most severe consequences of engaging in a prohibited transaction comes from the excise taxes that are imposed by the Internal Revenue Code. Section 4975(a) of the Internal Revenue Code levels a fifteen percent tax on the amount involved in a prohibited transaction for each year (or part thereof) of the taxable period.<sup>76</sup> The tax is imposed on the disqualified person who participated in the prohibited transaction.<sup>77</sup> This means that a businessperson who owns ten percent or more of a company and sells his shares to an ESOP (which would make him a disqualified person under the Internal Revenue Code and a party in interest under ERISA) would be liable for any excise taxes imposed under § 4975. This potential liability provides a strong incentive for owners of a business selling their shares to an ESOP to properly value the shares that are being sold.

However, as if the fifteen percent excise tax on prohibited transactions was not enough, § 4975(b) provides for a second tier of tax if the prohibited transaction is not corrected within the taxable period.<sup>78</sup> When a tax is imposed by § 4975(a) on any transaction and that transaction is not corrected within the taxable period, a 100% tax is levied on the transaction.<sup>79</sup> Essentially, this means that when a disqualified person engages in a prohibited transaction that triggers the fifteen percent excise tax, the transaction must be unwound within the taxable period or the entire amount involved will be subject to the 100% excise tax. Again, any tax that is imposed by § 4975(b) of the Internal Revenue Code must be paid by the disqualified person who engaged in the prohibited transaction.<sup>80</sup> This provision of the Internal Revenue Code imposes serious consequences if a prohibited transaction between an ESOP and a selling owner is not unwound within the taxable period, as the entire amount involved in the transaction will be subject to the excise tax and the selling owner will be liable for that amount.

A sale of an owner's stock in a company to an ESOP constitutes a prohibited transaction since it involves a sale of property between a disqualified person and the plan.<sup>81</sup> However, the excise taxes that would be levied against a selling owner who engages in a prohibited transaction can be avoided if the ESOP received adequate consideration for the securities

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<sup>76</sup> I.R.C. § 4975(a) (2006).

<sup>77</sup> *Id.*

<sup>78</sup> I.R.C. § 4975(b).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> I.R.C. § 4975(c)(1)(A).

that were purchased.<sup>82</sup> For selling owners who own stock in closely held businesses, adequate consideration is often difficult to determine since shares of the company's stock are frequently not publicly traded and are not easy to value. When selling prices or bid and ask prices are unavailable, fair market value should be determined by considering the company's net worth, prospective earning power, dividend-paying capacity and other relevant factors.<sup>83</sup> These "other relevant factors" can include the goodwill of the business, the economic outlook for a particular industry, the company's management, the company's position in the industry, the degree of control in the company that is represented by the stock that is being sold, and the values of other companies that are engaged in the same or similar lines of business which are listed on a public stock exchange.<sup>84</sup> "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."<sup>85</sup>

## V. ILLUSTRATIONS OF VALUATION ISSUES

There are many ways in which problems with valuation of the consideration received by an ESOP can adversely affect an otherwise beneficial ESOP transaction. The following three cases illustrate many of the potential pitfalls which may be encountered during the valuation process.

### A. *Henry v. Champlain Enterprises*

In *Henry v. Champlain Enterprises*, the defendant fiduciaries of an ESOP were alleged to have failed to satisfy their fiduciary duties by allowing the ESOP to pay more than fair market value for the employer securities being purchased.<sup>86</sup> The court below had found that the fiduciaries were liable to the plaintiffs for over \$15 million in damages.<sup>87</sup> However, in reversing that decision, the Second Circuit Court found that the defendant

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<sup>82</sup> I.R.C. § 4975(d)(13) (2006). This exemption from the excise taxes is worded in a slightly more complicated manner in the actual statute. The statute states that the excise taxes will not be imposed on any transaction which is exempt from 29 U.S.C. § 1106 by reason of 29 U.S.C. § 1108(e). As discussed previously, these provisions of ERISA prohibit sales between an employee stock ownership plan and a party in interest, then exempt any transaction from the ban that is made for adequate consideration. *See also infra* Part IV B.

<sup>83</sup> *Capital City Excavating Co. v. Comm'r*, 47 T.C.M. (CCH) 1527 (1984).

<sup>84</sup> *Id.*

<sup>85</sup> Rev. Rul. 59-60, 1959-1 C.B. 237.

<sup>86</sup> *Henry v. Champlain Enters.*, 445 F.3d 610, 613 (2d Cir. 2006).

<sup>87</sup> *Id.*

fiduciaries had acted in good faith in determining the fair market value of the securities being purchased by the ESOP.<sup>88</sup>

The dispute in *Henry* arose after CommutAir, a regional airline company, decided to pursue the establishment of an ESOP.<sup>89</sup> CommutAir was owned by three men, each with a one-third share of the company.<sup>90</sup> The sellers circulated an offer to the representatives of the proposed ESOP that they would sell thirty percent of the company, in the form of convertible preferred stock, for \$60 million.<sup>91</sup> Subsequently, the trustee of the ESOP engaged a financial appraisal firm to ascertain the value of the CommutAir securities being sold and to provide a "fairness opinion" that detailed whether the transaction was fair to the ESOP.<sup>92</sup>

As part of the appraisal process, representatives from the appraisal firm and the trustee met with senior management from CommutAir in order to perform a due diligence review.<sup>93</sup> Following this analysis, negotiations were entered into between CommutAir and the ESOP which resulted in improvements in the offer to the ESOP, including an increase in the dividend rate of the stock being acquired.<sup>94</sup> However, the proposed purchase price of \$60 million remained the same, despite the fact that the initial valuation of CommutAir indicated that the thirty percent share of the stock was worth no more than \$54 million.<sup>95</sup>

Shortly thereafter, the trustee of the ESOP received the valuation firm's detailed report which contained a description of the valuation methodology and stated that the ESOP was paying a price not more than the fair market value of the CommutAir stock.<sup>96</sup> A stock purchase agreement was then executed between the selling owners, CommutAir, and the trustee of the ESOP with a purchase price of \$60 million.<sup>97</sup> However, plaintiffs in the *Henry* case claimed that the ESOP had engaged in a prohibited transaction because the trustee had failed to satisfy the good faith requirements which must be met in order for a transaction between an ESOP and an interested party to qualify under the good faith exception in ERISA § 408.<sup>98</sup>

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<sup>88</sup> *Id.* at 621.

<sup>89</sup> *Id.* at 613–14.

<sup>90</sup> *Id.* at 613.

<sup>91</sup> *Id.* at 614.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 615.

<sup>94</sup> *Id.* at 616.

<sup>95</sup> *See id.*

<sup>96</sup> *Id.* at 616–17.

<sup>97</sup> *Id.* at 617.

<sup>98</sup> *Id.*

The court found that the trustee of the CommutAir ESOP had acted in good faith during the ESOP transaction with the selling owners.<sup>99</sup> The Second Circuit found that the detailed investigation and analysis that had been conducted was enough to show that the trustee had acted as a prudent fiduciary under the circumstances at the time of the transaction.<sup>100</sup> Supporting this conclusion were findings that the trustee had reviewed the valuation firm's preliminary valuation, met with the valuation firm to discuss various concerns with the data, and succeeded in having the report amended to reflect those concerns.<sup>101</sup> Furthermore, the court stated that the position of the ESOP had improved throughout the trustee's tenure which resulted in alterations to the valuation of CommutAir beneficial to the ESOP before the valuation was finalized.<sup>102</sup> Therefore, the judgment assessing damages to the fiduciary for the ESOP was reversed.<sup>103</sup>

#### *B. Eyler v. Commissioner*

In *Eyler v. Commissioner*, the former CEO and majority shareholder of Continental Training Services ("CTS") was held liable for excise taxes assessed by the Internal Revenue Service ("IRS") after it was determined that he had engaged in a prohibited transaction with CTS's ESOP.<sup>104</sup> The Tax Court had found that the majority shareholder, Eyler, had not demonstrated that the fair market value of stock he sold to the ESOP was at least equal to the price per share he received.<sup>105</sup> Furthermore, the Tax Court stated that Eyler had not shown that any fiduciary for the ESOP had made a good faith determination that the value of the stock received by the ESOP was at least equal to the price paid to Eyler.<sup>106</sup> For reasons to be explored below, the Seventh Circuit Court of Appeals affirmed the Tax Court's decision.<sup>107</sup>

In 1985, CTS was undergoing a period of strong growth and Eyler decided to explore the possibility of taking the company public.<sup>108</sup> To this end, Prudential-Bache Securities was retained by CTS as an underwriter for a possible initial public offering.<sup>109</sup> During 1986, Prudential-Bache performed an extensive due diligence review of CTS's financial records and determined that CTS stock could possibly be marketed between a range of

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<sup>99</sup> *Id.* at 621.

<sup>100</sup> *Id.* at 620.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 620–21.

<sup>103</sup> *Id.* at 624.

<sup>104</sup> *Eyler v. Comm'r*, 88 F.3d 445, 447–48 (7th Cir. 1996).

<sup>105</sup> *Id.* at 448.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.* at 456.

<sup>108</sup> *Id.* at 448.

<sup>109</sup> *Id.*

thirteen and sixteen dollars per share in an IPO.<sup>110</sup> However, this price range was not considered binding and the underwriter would be free to market CTS stock at a price outside the range.<sup>111</sup> In November 1986, Prudential-Bache marketed the proposed IPO to possible public purchasers at a price between thirteen dollars and sixteen dollars, but the public interest in the CTS IPO at that price was only roughly \$1 million.<sup>112</sup> Due to the lack of public interest in the IPO, CTS decided to postpone the IPO until a time when the market was more robust.<sup>113</sup> Soon thereafter, Eyler decided to look into the establishment of an ESOP for CTS, to which he could then sell his shares.<sup>114</sup> Pursuant to this plan, CTS approached a bank about a \$10 million loan, secured by the shares to be sold to the ESOP, which would allow the ESOP to purchase Eyler's shares.<sup>115</sup> On December 12, 1986, Perry, the financial consultant for CTS, presented the terms of the proposed ESOP to the board of CTS, which included naming CTS as a fiduciary to the ESOP.<sup>116</sup> After some discussion, the board approved the establishment of the ESOP under the terms Perry had discussed and it was decided that the ESOP, by way of the bank's loan, would purchase \$10 million of stock from Eyler at a price of \$14.50 per share.<sup>117</sup> The loan would be guaranteed by CTS and Eyler individually.<sup>118</sup>

Under the loan agreement, which was executed on December 22, 1986, CTS was required to make contributions to the ESOP that would allow the ESOP to make payments on the loan, which called for \$2 million in principal payments annually.<sup>119</sup> Furthermore, the loan agreement placed several restrictions on CTS: borrowing ability and capital expenditures would be limited, and a moratorium on dividend payments was likely.<sup>120</sup> Notably, in late 1986 or early 1987, several members of the CTS board purchased shares of stock from the minority shareholder of CTS at a price of \$14.50 per share.<sup>121</sup> All but one of the directors financed their purchases through "informal, unsecured 'bridge loans [from Eyler],' the terms of which were not reduced to writing."<sup>122</sup>

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<sup>110</sup> *Id.* at 448-49.

<sup>111</sup> *Id.* at 449.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 450.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*



In the subsequent months, CTS made some poor investment decisions and suffered great financial losses when the federal government withdrew its eligibility to participate in key government student loan programs.<sup>123</sup> In 1989, CTS was forced to file for bankruptcy and the company was eventually liquidated.<sup>124</sup> Thereafter, the IRS investigated the transaction between Eyler and the ESOP and determined that Eyler was liable for excise taxes for engaging in a nonexempt prohibited transaction.<sup>125</sup> Eyler argued that the shares purchased by the ESOP had a fair market value equal to the purchase price of \$14.50 and that the board of CTS had made a good faith determination that the price paid by the ESOP for the shares was adequate consideration.<sup>126</sup>

The Court of Appeals, in affirming the Tax Court, stated that the Prudential-Bache IPO report could not be used to establish the fair market value of the shares of CTS at \$14.50.<sup>127</sup> The court noted that the price of \$14.50, given by Prudential-Bache, was merely a recommendation and was not a final determination of price, as it could have been altered by the underwriters prior to the IPO.<sup>128</sup> Furthermore, the court stated that the lack of public interest in CTS stock at a price between thirteen dollars and sixteen dollars showed that the fair market value of the stock could not be established by the \$14.50 recommendation.<sup>129</sup> Additionally, the underwriter's valuation report was based on assumptions that CTS would become a publicly traded company and that the IPO would result in positive cash flow for CTS, neither of which came to pass.<sup>130</sup> Also, CTS's cash flow actually worsened when the ESOP was established since the company committed itself to making contributions to the ESOP that would cover the loan payments to the bank.<sup>131</sup> When combined with the restrictions on dividends, capital expenditures, and further borrowing that were imposed by the bank, the court found that the aforementioned flaws in the Prudential-Bache valuation precluded the \$14.50 recommendation from providing a basis for the determination of fair market value.<sup>132</sup>

The court also ruled that the stock purchases by directors of CTS at \$14.50 did not establish that the fair market value of the stock sold to the ESOP was equal to \$14.50 since the sales were not arm's length

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<sup>123</sup> *Id.* at 450–51.

<sup>124</sup> *Id.* at 451.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 452.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.* at 452–53.

transactions.<sup>133</sup> Eyler himself benefitted from the transactions, since he was attempting to establish that the fair market value of the shares was \$14.50, and he provided unsecured, informal financing to the purchasing directors, which led the court to agree with the Tax Court's determination that the purchases were not at arm's length.<sup>134</sup>

It was also found that the ESOP's fiduciary, CTS, had not ensured that the ESOP paid adequate consideration by making a good faith determination that the fair market value of the shares was \$14.50.<sup>135</sup> The board of CTS approved the ESOP transaction on the basis of a four-month-old IPO report and without undertaking an independent inquiry into the current fair market value of Eyler's shares.<sup>136</sup> Additionally, Eyler produced no evidence to show that the board properly considered the substantial financial effect the ESOP would have on CTS, such as the impact of contributions to the ESOP and the loan guarantee.<sup>137</sup> Furthermore, the fact that the board may have relied on Perry's opinion was not enough to show that they had exercised their own judgment regarding the ESOP transaction.<sup>138</sup> Finally, the court noted that the short time period in which the ESOP was proposed and implemented showed that the board, acting as the ESOP's fiduciary, did not have adequate time to engage in its own analysis of the proper valuation for Eyler's shares of CTS stock.<sup>139</sup>

In the end, the court observed that not a single director of CTS had made any sort of independent investigation into the value of the stock that was being acquired by the ESOP.<sup>140</sup> This simply did not comport with the obligations of a fiduciary attempting to make a good faith determination of fair value, as "the degree to which a fiduciary makes an independent inquiry is critical."<sup>141</sup> The court made it clear that no prudent person would have relied on data from a failed IPO that was based on faulty assumptions and a completely different financial climate.<sup>142</sup>

### C. *Capital City Excavating Co. v. Commissioner*

In *Capital City Excavating Co. v. Commissioner*, the IRS determined that Capital City was responsible for paying excise taxes resulting from the

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<sup>133</sup> *Id.* at 454.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 455.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 455-56.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

sale of company stock to Capital City's ESOP.<sup>143</sup> The IRS asserted that the sale of stock by Capital City to the ESOP was a prohibited transaction under the Internal Revenue Code.<sup>144</sup> However, for reasons discussed below, the Tax Court found that Capital City was not liable for excise taxes, as the sale of stock to the ESOP was for adequate consideration.<sup>145</sup>

Capital City was a closely held corporation and its shares of stock were not traded on any public exchange.<sup>146</sup> The company also had two classes of stock—AA (voting common stock) and A (nonvoting common stock).<sup>147</sup> On December 31, 1975, Capital City's directors consented in writing to the sale of nearly 100 shares of voting common stock at a price of \$100 per share to several directors and key employees of Capital City.<sup>148</sup> These sales were voluntary on the part of the purchasers and took place in 1976.<sup>149</sup> The December 31 agreement also authorized the sale of 1000 shares of stock to the Capital City ESOP for a purchase price of \$100,000, or \$100 per share.<sup>150</sup> This per share value was calculated by Capital City's treasurer, Ralph Walls, who was a trustee of the ESOP, and a director and purchaser of some of the shares of stock made available by the December 31 agreement.<sup>151</sup>

Walls determined the \$100 price by examining the 1974 balance sheet of Capital City and making adjustments to the operating results and net worth of the company.<sup>152</sup> After making these adjustments to the book value of Capital City, Walls divided the total book value by the number of shares outstanding, which resulted in a per share value of nearly \$112.<sup>153</sup> Based on this valuation, the price of the shares to be sold to the ESOP was set at \$100.<sup>154</sup>

However, the IRS determined that the value of the shares sold to the ESOP was only seventy dollars per share, which would mean that the ESOP had paid more than adequate consideration for the stock and had engaged in a prohibited transaction with Capital City.<sup>155</sup> An expert witness for the IRS compared Capital City to five other similar companies that were publicly traded over the counter and concluded on the basis of regression analysis

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<sup>143</sup> *Capital City Excavating Co. v. Comm'r*, 47 T.C.M. (CCH) 1527 (1984).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 1532.

<sup>146</sup> *Id.* at 1528.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.* at 1529.

that Capital City's shares were only worth seventy dollars per share.<sup>156</sup> An expert witness for Capital City maintained that the per share value of Capital City stock was \$142, which was calculated by taking the estimated net asset value of the company and discounting it by ten percent, to reflect the lack of marketability of the company's shares.<sup>157</sup>

The court stated that Capital City needed to prove that the sale of stock was for adequate consideration, a standard which "requires not only that the purchase *price* reflect fair market value, but also that the *process* by which the price was set conform to established standards of fiduciary care."<sup>158</sup> When considering whether the sale was for adequate consideration, the court was required to balance two competing policies: the protection of beneficiaries of the ESOP and the congressional policy of fostering the use of ESOPs.<sup>159</sup> Essentially, if the per share value of Capital City stock was greater than or equal to \$100, Capital City would not be liable for excise taxes, since the sale would have been for less than adequate consideration and the interests of beneficiaries of the ESOP would be protected.<sup>160</sup>

The court noted that when determining the value of stock of a closely held corporation, the best indicators of fair market value are actual arm's length sales of the corporation's stock that occur within a reasonable time before or after the date of valuation.<sup>161</sup> Furthermore, valuation is not an exact science and the process used in a particular case will depend on the various facts and circumstances.<sup>162</sup> Additionally, the court pointed out that the consideration of the proper per share price should not be restricted to only one method of valuation, as there are various approaches to valuation that can be appropriate based on the situation.<sup>163</sup> While the method of valuation used by the IRS was an accepted form of valuation, the court stated that Capital City's method of valuation and its accompanying explanations of adjustments were reasonable under the circumstances.<sup>164</sup>

Of some importance to the court was the fact that Capital City had simultaneously sold shares of stock to several directors and key employees at the same price as the shares sold to the ESOP.<sup>165</sup> While these sales were admittedly not at arm's length since the stock was sold to insiders of Capital City, the court found that this supported Capital City's valuation, as

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<sup>156</sup> *Id.* at 1532.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.* at 1532 (emphasis in original).

<sup>159</sup> *Id.* Congress's policy of fostering the use of ESOPs is discussed in greater detail in *Donovan v. Cunningham*, 716 F.2d 1455, 1466 (5th Cir. 1983).

<sup>160</sup> *Capital City*, 47 T.C.M. (CCH) at 1528.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 1530.

<sup>165</sup> *Id.*

insider sales tend to be artificially low.<sup>166</sup> This suggested that Capital City's ESOP actually paid a lower price than the shares were actually worth.<sup>167</sup>

The court concluded that the \$100 per share price paid by the ESOP was adequate consideration because the process used by Capital City to value the shares sold was reasonable and in accordance with fiduciary standards.<sup>168</sup> While the use of an independent appraisal would have been helpful, the methods employed by Capital City in valuing its stock were permissible and fairly reflected the value of the shares purchased by the ESOP.<sup>169</sup> Since the sale was for adequate consideration, Capital City was relieved of the obligation to pay excise taxes on the transaction.<sup>170</sup>

## VI. CONCLUSION

The need for proper valuation of securities being sold to an ESOP by a selling owner is obvious, considering the various prohibitions and excise taxes that can result from engaging in a prohibited transaction. If an entrepreneur is not careful, he or she could end up being liable for taxes up to 100% of the amount involved in the transaction. Despite all of the potential pitfalls that can arise during a sale of securities to an ESOP, there are certain steps that can be taken by a selling owner to ensure that any prohibited transaction is structured so that it qualifies for the statutory exemption.

One of the most important things that can be done by a selling owner is to hire an independent appraiser to value the company stock that is being sold to the ESOP. While an independent appraisal on its own is not sufficient to qualify a transaction for the exemption granted by ERISA and the Internal Revenue Code, it certainly helps to show that the selling owner is making an honest attempt to provide adequate consideration to the ESOP. The independent appraiser should be given all the information necessary to make an informed judgment about the true value of the company. It is especially important for closely held businesses that are not traded on a stock exchange, since the appraiser's job is more difficult when there is no history of transactions in the stock on which to rely. Furthermore, the trustee for the ESOP should be sure to discuss the valuation report with the appraiser. It ensures that the trustee fully understands the methodology that was employed by the appraiser in valuing the company stock and also helps the trustee to determine if the ESOP is receiving adequate consideration in the sale.

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<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 1532.

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

It is also extremely important for a selling owner to remove himself from the valuation process as much as possible. It is crucial to prevent any inference that the transaction process was influenced by the owner. If the selling owner exercises too much influence over the valuation process, the IRS or the courts could conclude that the ESOP did not actually receive adequate consideration in the transaction between the plan and the selling owner. A determination that the selling owner influenced the valuation of the company stock being sold to his or her benefit could disqualify the transaction from the "prohibited transaction" statutory exemption. Given the avalanche of excise taxes and the necessity of unwinding any prohibited transaction, the costs to an entrepreneur of failing to qualify for the exemption can be extraordinarily high.

Transactions between selling owners of a business and an ESOP can be very beneficial for both the selling owner and the employees who participate in the ESOP. However, even the most well-intentioned transaction can go awry if valuation of the company stock being purchased by the ESOP is incomplete, inaccurate, or influenced by the selling owner. Entrepreneurs who are considering selling some or all of their company stock to an ESOP should beware of the potential pitfalls, but with careful planning the many benefits of selling stock to an ESOP can be realized, thus providing advantages for both the entrepreneur and his or her employees.